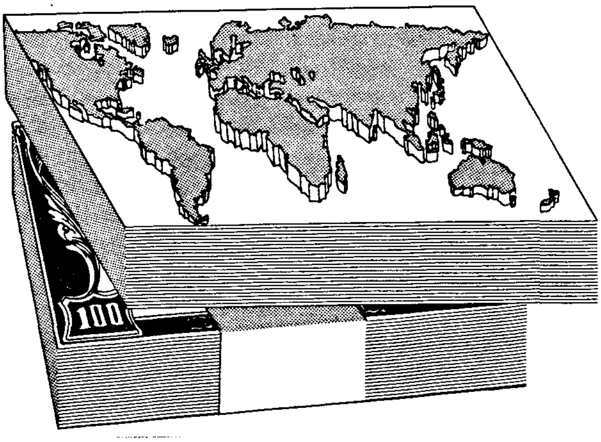
The World Economy



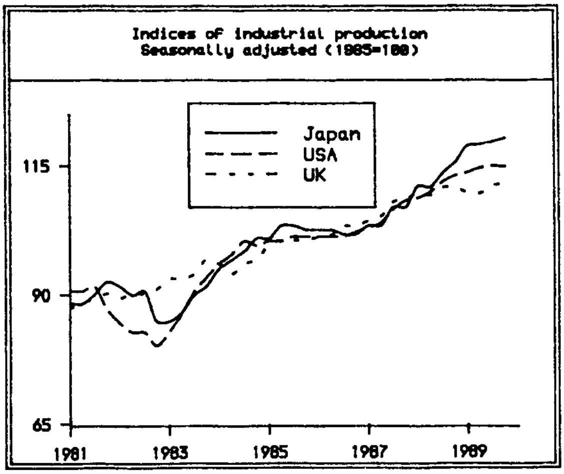
MACROECONOMIC TRENDS

The growth of Gross Domestic Product slowed rapidly for the major industrialised countries in the last quarter of 1989. GDP growth for the G7 countries averaged just 0.5 between October and December; for the whole of 1989 growth averaged 3.3% compared with 4.5% in 1988. Most rapid growth during 1989 was experienced in Japan (4.9%), with the lowest being the UK (2.1%). The remaining G7 countries (excluding Italy) were as follows: France 3.4%; West Germany 3.9%; Canada 2.87%; USA 3.0%.

There was also some slowing down in industrial production in the last quarter of 1989, and for the year as a whole OECD countries averaged 2.6% growth. In January industrial production fell in four of the G7 countries and was static in another; only France and Japan showed slight increases. The result of this was that industrial production in the G7 countries rose by just 1.3% in the year to January, just half the annual rate of the year to October 1989. In the twelve months to January growth rates among the G7 varied from West Germany and Japan at 4.6% and 3.4% respectively to Canada at -0.2%.

As production slows so there is evidence of sharply rising inflationary pressure. In the twelve months to February consumer prices rose by 6.4% in the OECD countries and by 4.9% for the G7 countries. There were mixed performances in the early part of 1990 - prices surged rapidly in Japan, bringing the yearly inflation rate up to 3.6%, while France was able to prevent any further rise in the annual rate of inflation above 3.4%. In addition, producer prices in France fell steadily throughout the second half of 1989, the only G7 country to achieve this feat. Indeed, France has earned plaudits from the OECD for its economic policy which has enabled the country to achieve both faster growth and lower inflation than the OECD averages for the first time in 20 years. In large measure this has been achieved by resorting to a tight monetary policy, which has had some cost in terms of unemployment (see Labour Market).

Other consumer price rises in the year to February were as follows: UK 7.5%; Italy 6.2%; Canada 5.4%; US 5.3%; West Germany 2.7%.



Labour Market

Unemployment fell steadily in most OECD countries during 1989, but there is some evidence now of a levelling off in this decline. In January average OECD unemployment was 6.0% with G7 countries averaging 5.5%. The only country among the G7 to significantly improve its performance was Italy, where unemployment fell to 10.5% in January having been above 11% in the third quarter of 1989.

Other unemployment levels were as follows (as at February): Japan 2.1%; France 9.4%, West Germany 5.4%; UK 5.7%; Canada 7.6%; US 5.2%

United States

During the early part of this year, Alan Greenspan, Federal Reserve Chairman, made a number of public statements to the effect that fears of a recession in the United States had all but disappeared. He further argued that inflation could be reduced steadily without the need for any adverse impact on employment.

Since Mr Greenspan's comments, however, there seems to be some evidence of renewed weakness in US demand which may once again raise the possibility of recession. After sharp rises in December and January the value of retail sales fell by 0.3% in February and by a further 0.6% in March, the first time since 1986 in which there have been successive monthly falls in retail sales. In addition, housing starts fell during both March and April and construction activity as a whole remains depressed. Fairly tight monetary policy has led to sluggish demand for credit and for consumer goods generally, a potential problem when policy is geared towards domestic demand as the principal engine of growth.

On a more positive note, industrial production has recovered from its January slump, rising by 0.5% in February and 0.7% in March; the March rise was much greater than expected and was boosted by a recovery in car manufacture which had previously been very depressed. Orders for durable goods also rose sharply in March, an increase of 6.7% being the largest monthly increase for two years.

One effect of the relatively sluggish domestic demand has been a reduction in the deficit on the current account of the balance of payments, which narrowed by $20.6 billion in 1989 to $105.9 billion. This improvement carried on during the early part of 1990. The trade deficit fell in February to $6.1 billion, but widened again to $8.45 billion in March; however, this unexpected widening was entirely due to seasonal adjustments which are always particularly suspect around the Easter period. Over the first quarter of 1990 exports continued to grow at around twice the rate of imports, another facet of the slowdown in consumer demand.

Unofficial forecasts of GDP growth for 1990 are now being reduced from around 2.6% to nearer 2%, although some forecasters feel that even this may be optimistic given the weakness of domestic demand. It should be noted, however, that the US economy has so far proved to be very resilient to a tight monetary policy and may continue to be so. But there is now more concern about inflation, which rose sharply in March. Consumer pries are now rising at an annual rate of above 5% for the first time in many years, and there is some concern now about the underlying rate of inflation. "Core inflation", which covers all items except food and energy, reached 7.5% in the first quarter, having been steady at around 4.5% for the previous six years.

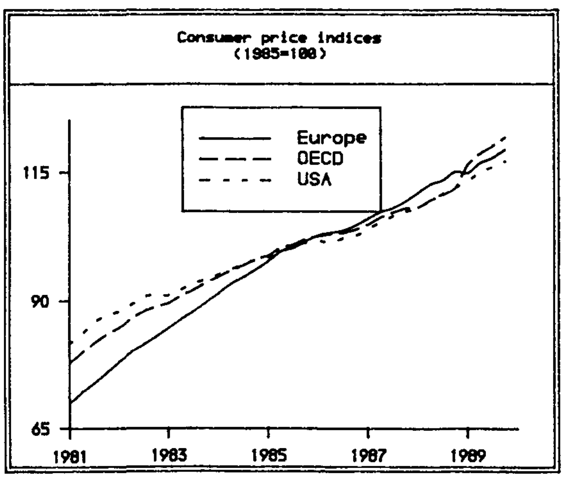
Japan

In 1989 the Japanese economy performed well, with steady economic growth lead by strong domestic demand. Real GNP grew by 4.9% during the year, helped by consumer expenditure which was fairly buoyant despite the imposition of a consumption tax. Industrial production rose by 6% during the year. However, 1990 may not prove to be so satisfactory.

In the last Commentary some mention was made of instability in the Japanese financial and currency markets. Over the last quarter this appears to have worsened. The main problem relates to the fall in the Yen; during 1989 it fell by 13.6% (in trade-weighted terms), and fell by a further 9% in the first quarter of 1990. Various factors have accounted for the weakness of the Yen, including Japan's narrowing current account surplus (of which more later), the rapid growth in the money supply, the substantial differences between the real interest rates of Japan and her major competitors, and the enthusiasm of the Japanese for overseas investment.

In late March the official discount rate (ODR) was finally raised by one percentage point to 5.25%, which represented a doubling of nominal interest rates within a year. This had very little effect on the value of the Yen, partly because it appeared to have been fully discounted by the market, and partly because the ODR follows rather than leads interest rate movements following deregulation of interest rates.

Rather ironically, one of the reasons for the Yen's weakness has been Japan's success in reducing its balance of trade surplus, one of the major areas of dispute among G7 countries in recent years. The 1989 current account surplus of $57 billions (revised) was the lowest for three years, and surpluses in January and February of $3.0 billion and $5.2 billion do suggest that some progress is being made in this respect. The continuing weakness of the Yen could, however, jeopardise this improvement once the J-curve effect of a steady fall begins to unwind. There is also the problem of import prices rising sharply as a result of the fall in the Yen's value, which feeds into inflation. Officially, it is felt that inflation is not yet a problem about which Japan should be concerned; after allowing for the once-off effect of last year's 3% consumption tax, consumer prices are now rising at little over 1.5% per annum. However, apart from the Yen's weakness there are other inflationary pressures building up, such as an acceleration in the money supply and a very tight labour market which will probably result in average wage rises in 1990 above the 5.2% of 1989.



West Germany

In 1989 West Germany remained one of the fastest-growing OECD economies. GDP grew 3.9% compared with a G7 average of 3.3%, and West German industrial production grew by over 4% compared with a 2.6% OECD average. In the twelve months to February German inflation remained steady at 2.7%, while all other G7 countries (with the exception of France) experienced marked surges in consumer prices.

This satisfactory outcome was achieved by a combination of relatively relaxed fiscal policy (including personal and corporate tax reforms) and tightening monetary policy. The D-Mark has strengthened noticeably in recent months, especially against the Yen, and continuing relatively high interest rates in West Germany have caused some difficulties for the Japanese authorities in this respect.

While much of the growth of the West German economy during 1988 and 1989 has been external in origin, aided by very buoyant international trade, the focus of attention is now becoming increasingly inward as preparations proceed for German unification. It now seems likely that unification will take place by 1992, and will be preceded by monetary union.

All of these issues raise difficulties for policy makers, such as the extent of immigration into West Germany from the East (over 160,000 people in the first three months of 1990), the proportion of their income and wealth which will be spent by these immigrants, itself to some extent dependent on conversion rates, and the effect which immigration of this extent has on the West German economy.

In the best scenario the economy of West Germany will benefit in at least two distinct ways. First, the new influx should result in a substantial boost to domestic demand. The problem here lies in the possibility of supply-side constraints which would tend to increase inflationary pressure. Despite buoyant investment expenditure over the last two years, production potential is now estimated to be growing at below the rate of increase of domestic demand, creating possible problems when capacity utilisation is already high. While immigration cannot directly affect capital investment, the second benefit is to the supply side; an influx of skilled workers may help to alleviate skilled labour shortages and so reduce inflationary pressures from that side.

Overall, most forecasts now expect West German GNP to increase between 3% and 3.5% in 1990, with high utilisation rates ensuring that investment remains high despite relatively high interest rates.

Prognosis

Despite recent problems in the Japanese financial and foreign exchange markets, the balance of evidence still indicates that the G7 countries are continuing to achieve a reasonably co-ordinated economic slowdown.

In its latest World Economic Outlook, the IMF took an optimistic stance, anticipating world growth of 2.25% in 1990 followed by 3% in 1991. The main impetus to growth is expected to come from Japan, France, West Germany and the US - where a recession is not expected. The growth of international trade has been one of the major driving forces behind the expansion of the world economy in the last six years, and the latest forecast from GATT indicates continued growth, although below the levels recorded in 1988 and 1989. World trade volume is forecast to grow by between 5% and 6% this year, compared with 7% in 1989 and 8.5% in 1988.

This forecast fits well with the IMF's optimistic growth projections. However, both GATT and the IMF have cautioned about the need for continued monetary restraint in order to restrain inflation, with the emphasis on the maintenance of high interest rates; the Fund is in no doubt about the link between the reduction of inflation in recent years and a prolonged period of output and employment expansion.